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PRIVATIZATION OF OLD-AGE PENSIONS IN LATIN AMERICA: LESSONS FOR SOCIAL SECURITY REFORM IN THE UNITED STATES

MICHAEL ALAN PASKIN

INTRODUCTION

The United States Social Security¹ system has been criticized both for its inability to generate national savings to promote investment and its long-term inability to pay for itself when the current working generation of baby-boomers retires. In Latin America, a region that frequently follows rather than establishes North American economic trends, several governments have initiated a variety of reforms to privatize their social security systems. By learning from its neighbors to the south, the United States can restructure its own pension system to succeed in the next century.

Part I of this Note discusses the historical development of the Social Security system in the United States.² This Part explores various contemporary criticisms, focusing on the inability of the present "pay-as-you-go" system to generate national savings and investment, and the long-term infeasibility of the continued existence of the Social Security system in the United States.

Part II examines how several Latin American governments reformed their social security systems by wholly or partially replacing state-run retirement insurance schemes with privately-managed pension funds.³ This Part focuses on three case studies of Latin American social security: Chile, which was the first Latin American country to privatize its social security system in 1981,⁴ and Argentina⁵ and Mexico,⁶ two countries that have adopted the Chilean model, partially replacing or supplementing their state-run social security systems with private pension schemes.

Part III demonstrates that the privatization of old-age pensions, like that instituted in Latin America, is a feasible option for social security reform in the United States.⁷ Through Parliament's passage of legislation in 1975 and 1986, the United Kingdom adopted a private alternative

1. Throughout this Note, the term "social security" refers exclusively to old-age pensions paid by the government to retirees, and does not include other elements of a comprehensive national social insurance program such as health care and disability. The terms "social security" and "pension" are used interchangeably. Furthermore, when capitalized, Social Security refers exclusively to the social security system in the United States, as created by the Social Security Act of 1935 and subsequent amendments. See 42 U.S.C. § 301 (1988).

2. See *infra* part I.A-B.

3. See *infra* part II.

4. See *infra* part II.A.1.

5. See *infra* part II.A.2.

6. See *infra* part II.A.3.

7. See *infra* part III.A-B.

to social security,⁸ demonstrating that privatization can be implemented successfully in an industrialized nation. While the United States is far more industrialized and economically developed than its Latin American neighbors, it shares similar goals in implementing options for social security reform. Today, the United States seeks to solve similar problems to those that Latin American countries sought to remedy by privatizing their social security systems. Primarily, these problems are the need to stimulate saving and investment on a national basis and to guarantee the survival of old-age insurance in the United States through the next century. Furthermore, allowing workers to invest their retirement contributions with private, competitive pension funds will make financial markets more accessible to all segments of the population, resulting in a positive impact on the inequitable distribution of wealth in the United States.

I. SOCIAL SECURITY IN THE UNITED STATES

The current system of Social Security in the United States is becoming a fiscal burden to the government and it fails to generate adequate levels of national savings and investment.

A. *Development and Current Structure of Social Security in the United States*

The first form of a national public pension scheme in the United States was military pensions.⁹ Initially, tariff revenues were the primary source to fund these pensions.¹⁰ Early in the nineteenth century, the collection of these tariffs began, in limited form, to pay disability pensions for Revolutionary War veterans. The tariffs continued to be the major source of funding for military pensions following the Civil War. Congress enacted several pieces of legislation during the latter half of the nineteenth century to provide financial security for disabled Civil War veterans.¹¹ In 1912, Congress passed legislation specifying that simply being age sixty-two counted as a disability, resulting in the significant expansion in the number of pensions.¹² The Civil War pensions grew to the point where thirty percent of all men over age sixty-five in the United States received some benefit.¹³

While the Civil War pension legislation covered a substantial number

8. See Social Security Pensions Act, 1975, ch. 60 (Eng.); Social Security Act, 1986, ch. 50 (Eng.).

9. See John B. Williamson & Fred C. Pampel, *Old-Age Security in Comparative Perspective* 87 (1993).

10. See *id.*

11. See *id.* at 88-89. At first these Civil War pensions only covered service-related disabilities, under the 1862 Civil War Pension Act and the 1879 Arrears Act, but gradually expanded to include all veterans of the Civil War. See *id.* The 1890 Dependency Pension Act granted pensions to any veteran of the Union army who had served at least ninety days. See *id.*

12. See *id.*

13. See *id.* at 89.

of elderly Americans, the majority of the working population still received no government-sponsored pension benefits. Especially as the veteran population declined during the early twentieth century, some reformers began to call for a national system of old-age pensions.¹⁴ The development of national old-age pension systems in many European nations largely influenced these proposals.¹⁵ Throughout the first two decades of the twentieth century, many socialist-influenced reformers unsuccessfully introduced bills in Congress for the establishment of a national pension scheme.¹⁶ Both at the federal and state level, however, there was little support for the idea of a government-run pension system.¹⁷ One reason why national pension legislation failed during this period is that the forces of organized labor opposed a national pension scheme as a threat to the power and autonomy of the unions.¹⁸ Although there were some union or corporate-sponsored pensions for retired employees, no national legislation existed.¹⁹

As the American economy degenerated during the Great Depression, many of the corporate and union pension plans suffered from insufficient funding.²⁰ As early as 1925, the leaders of large corporations questioned the viability of corporate pension schemes, and began to support federal legislation. With most union pension plans facing bankruptcy in the early 1930s, the American Federation of Labor shifted its support in favor of public pensions.²¹ Some states enacted old-age pension legislation, and by 1931 eighteen states had passed legislation creating pension schemes for retirees.²² The Supreme Court, however, declared the first national pension legislation, the 1934 Railroad Retirement Act,²³ unconstitutional.²⁴

The instability of private sources of savings for retirement during the Depression brought increased popular and political support for a system of federal old-age pensions.²⁵ President Franklin D. Roosevelt used this

14. *See id.* at 89-92.

15. Germany was the first nation in the world to enact national compulsory old-age pensions, which it did in 1889. *See id.* at 22. The United Kingdom first legislated a national pension system under the Old Age Pension Act of 1908. *See id.* at 51.

16. *See id.* at 89-90.

17. Arizona was the only State to legislate an old-age pension system, in 1914. *See id.* at 90. This, however, was declared unconstitutional by the Supreme Court of Arizona in 1915. *See id.*

18. *See id.*

19. *See id.* at 90-92.

20. *See id.* at 92.

21. *See id.* at 91-92.

22. *See id.*

23. *See* Railroad Retirement Act, ch. 868, 48 Stat. 1283 (1934) (repealed).

24. *See* Railroad Retirement Bd. v. Alton R.R. Co., 295 U.S. 330, 362 (1935) (holding that the Act violated both the Due Process Clause and the Commerce Clause).

25. *See* Carolyn L. Weaver, *The Economics and Politics of the Emergence of Social Security: Some Implications for Reform*, in *Social Security: Prospects for Real Reform* 117, 128 (Peter J. Ferrara ed., 1985).

swelling support to push forward the Social Security Act of 1935,²⁶ which established a compulsory, contributory, earnings-related national pension system.²⁷

Initially, the Social Security Act of 1935 did not require the distribution of benefits until 1942.²⁸ This policy would have allowed the growth of a large trust fund of reserves, such that each worker essentially could fund his own retirement. By the late 1930s, however, large business interests opposed the build-up of reserves because it kept money out of the economy. Based on these concerns, Congress passed in 1939 the first amendments to the Social Security Act of 1935, calling for increased benefits, and advancing to 1940 the date on which the first pensions would be distributed.²⁹ Over the years, the benefits and extension of coverage under Social Security gradually have been liberalized.³⁰ In 1982, ninety-two percent of all Americans over age sixty-five received some Social Security benefit.³¹ The net effect of the liberalization of Social Security benefits throughout the 1970s was to make the system almost universal in terms of coverage, but to deplete the Social Security trust fund in the process. Recent legislation has attempted to rebuild the trust fund by cutting benefits and raising taxes in order to pay for the pensions payable to today's workers when they retire.³²

B. *Problems and Criticisms of the Current Social Security System in the United States*

The primary criticisms of Social Security in the United States focus on the long-term problems inherent in a pay-as-you-go system. Two major negative effects of the current pay-as-you-go system are: (1) with an aging population, a funding crisis in social security is inevitable when the generation of current workers retires; and (2) the funds contributed to Social Security through payroll taxes do not contribute sufficiently to na-

26. Social Security Act, ch. 531, 49 Stat. 620 (1935) (codified as amended at 42 U.S.C. §§ 301-1397 (1988)).

27. *See id.* §§ 201-10. The Act did not only provide old-age pensions, but constituted a comprehensive system of social insurance including welfare, disability, and medical coverage. *See id.* §§ 1-1105. When President Roosevelt addressed Congress in 1934 regarding the need for Social Security, he emphasized the comprehensive nature of his intended proposal, which would "provide at once security against several of the disturbing factors in life—especially those which relate to unemployment and old-age." 78 Cong. Rec. 10,771 (1934).

28. *See* § 202(a), 49 Stat. at 623.

29. *See* Social Security Act Amendments of 1939, ch. 666, 53 Stat. 1360, 1361.

30. Amendments passed in 1950 changed the benefit formula so that benefit eligibility was further moved forward. *See* Act of Aug. 28, 1950, ch. 809, 64 Stat. 477. During the Nixon administration, the process of liberalization of benefits advanced rapidly, with legislation calling for increased pension size, the indexing of benefits to account for inflation, and the creation of the Supplemental Security Insurance program. *See* Social Security Amendments of 1972, Pub. L. No. 92-603, 86 Stat. 1329.

31. *See* Williamson & Pampel, *supra* note 9, at 103.

32. *See* Social Security Amendments of 1977, Pub. L. No. 95-216, 91 Stat. 1509; Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65.

tional savings, and could be more wisely spent if invested to promote economic growth, rather than simply redistributing income from the younger generation of workers to the older generation of retirees.

1. Lack of Funds to Pay Future Pensions

As a result of the aging of the American population, the ratio of working Americans to retirees is falling steadily. This ratio will fall more rapidly as the baby boom generation retires in approximately fifteen years.³³

Since the 1983 amendments, annual Social Security surpluses gradually have shifted Social Security away from a true pay-as-you-go system, and the trust fund has grown steadily.³⁴ The problem with these surpluses, however, is that they have been used to offset the federal government budget deficit in other areas,³⁵ which results in a regressive tax rather than a trust fund, and fails to ease the Social Security burden on future generations.³⁶ These developments have prompted some analysts to criticize the policy of building the trust fund to pay for the baby boomers' retirement.³⁷

Without a valid trust fund, enormous tax increases will eventually be required to fund future Social Security benefits.³⁸ It has been suggested that without fundamental reform of the current system, the rising tax burden of Social Security on working Americans will lead to a political war between the young and the old.³⁹

2. Insufficient Savings and Investment

The second major drawback of the United States pay-as-you-go Social Security system is that it takes money away from savings. The promise of retirement pensions under Social Security acts as a disincentive to private saving in the United States, because Americans are not individually responsible for financing their retirements. When Social Security replaces private savings, money is not used productively for investment in

33. See Henry J. Aaron *et al.*, *Can America Afford to Grow Old: Paying for Social Security* 2-3 (1989). The proportion of the working-age population to senior citizens was five to one in 1985. By the year 2050, Aaron projects that this ratio will fall to about two and one-half to one. See *id.* (Table 1-1).

34. See *id.* at 1.

35. See *id.* at 6-7.

36. See John Wood, *Social Security: Invaluable or Outmoded?*, *Modern Maturity*, Apr.-May 1992, at 34 (Panel Discussion).

37. See, e.g., James L. Kilpatrick, *Neither Social Nor Secure*, *Nation's Bus.*, Jan. 1985, at 6. ("The present system of social 'insurance' supposedly relies upon a 'trust fund,' but the system is not insurance, and the trust fund is a joke.")

38. See Peter J. Ferrara, *Social Security: Prospects for Real Reform* 2 (1985). The 1985 OASDI Report estimated that to pay for the Social Security benefits promised to a worker entering the workforce in 1985, the Social Security payroll tax would need to be raised from 14.1 percent to 37.5 percent. See Haeworth Robertson, *The National Commission's Failure to Achieve Reform*, in *Social Security: Prospects for Real Reform* 37, 58 (Peter J. Ferrara *ed.*, 1985).

39. See Kilpatrick, *supra* note 37, at 6.

capital formation, which then causes a detrimental effect on the national income level.⁴⁰ Furthermore, because the rate of return on investment available through Social Security is well below those rates of return available on the open market, individuals have less money for their retirements than they would if their Social Security tax withholdings were invested privately in the capital markets.⁴¹

II. SOCIAL SECURITY IN LATIN AMERICA

Latin America has a rich history of social security. Most Latin American governments established national old-age pensions in the 1920s;⁴² this development, however, was stratified largely because of weak central governments and strong pressure groups, especially labor unions and political parties.⁴³ This stratification in the social security systems of Latin American countries led to widespread inequality of coverage and benefits levels in Latin American society. Latin American countries developed a general need to reform social security in such a way as to make the system more equitable and to expand coverage to the entire population.⁴⁴

During the Latin American debt crisis of the 1980s, many governments of the region faced additional problems with their social security systems. As these governments became bankrupt, it became imperative for them to reduce budgetary costs and to promote economic development through investment.⁴⁵

Many Latin American governments turned to privatization as a means to address these crises. Industrial privatization has been a region-wide trend throughout the past decade. Governments have sold state enterprises in order to raise short term money to finance their accumulated debt.⁴⁶ The sale of these inefficiently managed industries to private owners, and the resultant competition in the marketplace has promoted general economic growth throughout the region.⁴⁷

Privatization of social security generally is concurrent with, and seen as a complementary policy to, general industrial privatization programs in Latin America.⁴⁸ Privatizing of pension schemes has reduced the fis-

40. See Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security* 10 (1986).

41. See Peter J. Ferrara & John R. Lott, Jr., *Rates of Return Promised by Social Security to Today's Young Workers*, in *Social Security: Prospects for Real Reform* 13, 19-23 (Peter J. Ferrara ed., 1985).

42. See Carmelo Mesa-Lago, *Social Security in Latin America: Pressure Groups, Stratification, and Inequality* 5 (1978).

43. See *id.* at 10-14.

44. See *id.* at 14-16.

45. See William R. Long, *When the Safety Net Unravels*, *L.A. Times*, Aug. 14, 1991, at A1.

46. See Katherine Conradt, *A Brazilian Beat: Privatization Aficionados are Energized by Prospects in Brazil*, *Latin Fin.*, July-Aug. 1993, at 22, 22.

47. See *id.*

48. See *id.* at 24.

cal burden on Latin governments, and simultaneously has stimulated national savings and investment in capital formation in Latin America.

A. *Case Studies of Latin American Social Security Privatization*

The cases of Chile, Argentina, and Mexico provide three examples of the successful privatization process in Latin America. These nations clearly illustrate the problem of stratification and the inability to generate national savings and capital growth through a state run, pay-as-you-go social security system. Each country responded to these problems by privatizing social security to some degree, although each tailored its individual solution to match its particular political and economic climate.

1. Chile

In 1980, Chile privatized its social security system to relieve the government's administrative burden, eliminate the stratification and inequality that pervaded the pension system, and promote economic growth through saving and investment in private capital markets.⁴⁹ Because of its success, Chile's privatization program has become the Latin American model for social security reform.

a. *Developments Before Privatization*

Chile pioneered social security in the Western Hemisphere.⁵⁰ Despite social security's early appearance in Chile, a long period of intermittent development spurred by various political pressure groups, resulted in a system that was marked by inequality, stratification, and high costs to the government by the 1970s.⁵¹

In the nineteenth century and the early stages of the twentieth, only a few limited Chilean groups with significant political influence could secure legislation providing for old-age pensions. These groups included the military, civil servants, and railroad workers.⁵² The great mass of both blue-collar and white-collar workers, however, were not unionized sufficiently to exert the political pressure required to secure social security legislation.⁵³ The Mexican Revolution of 1917 spurred the labor movement in Chile and the adoption of a new Constitution.⁵⁴ The newly-found political force of labor supported the election of Arturo Alessandri Palma as President of Chile in 1920.⁵⁵ In 1924, the final year of his presidency, Alessandri overcame opposition in the Chilean Senate to pass legislation that would serve as the basis for Chile's social security

49. See Decree Law 3,500 (Chile 1980).

50. See Carmelo Mesa-Lago, *Ascent to Bankruptcy: Financing Social Security in Latin America* 105 (1989).

51. See Mesa-Lago, *supra* note 42, at 69.

52. See *id.* at 23-24.

53. See *id.* at 24.

54. See *id.*

55. See *id.*

system—pensions for blue and white-collar workers.⁵⁶

During the following four decades, Chilean social security gradually expanded until one plan or another covered the majority of the working population. This expansion, however, was achieved one pressure group at a time, and separate legislation protected each individual group of workers. Consequently, each industry had different pension benefits and its own governmental agency regulating and administering its pensions.⁵⁷ Carmelo Mesa-Lago has defined this phenomenon as the "massification of privilege."⁵⁸

This patch-work expansion of social security in Chile continued into the 1950s, when President Jorge Alessandri Rodríguez recognized the need to reform the system. Shortly after his election in 1958, Alessandri established a commission to examine Chile's social security system and to recommend reform measures.⁵⁹ The commission found the system to be "one of the most discriminatory in the world," and a regressive tax that was "made possible through the organization of the most powerful and wealthy groups into privileged funds separated from the common or general funds."⁶⁰ Despite the fact that Alessandri's commission had identified the need to unify benefits and the administration of social security and to extend protection to the self-employed and small employers, the powerful pressure groups permitted the passage of only minimal reform laws prior to 1973.⁶¹

In the early 1970s, there were thirty-one separate old-age pensions in the "system," each with its own legislation, administration, and financing.⁶² There was no single coordinating public authority. The system placed a huge financial burden on the Chilean government—in 1971, its operating costs represented seventeen percent of Chile's gross domestic product.⁶³ At this stage, President Eduardo Frei foresaw a grim future for the Chile's social security system, commenting that it was a "permanent source of instability and unrest [and] a paralyzing obstacle to the plans of economic development and social reform, . . . [leading] inevitably to the bankruptcy of the social security funds or to the bankruptcy of the country."⁶⁴

56. See *id.* at 25.

57. See *id.* at 26-28. Examples of individual industries whose workers received pension coverage during this period are petroleum (1933), racetracks (1936), and banks (1946). See *id.*

58. See Mesa-Lago, *supra* note 50, at 105.

59. See Mesa-Lago, *supra* note 42, at 28.

60. *Id.* (quoting Comisión de Estudios de la Seguridad Social, *Informe Sobre la Reforma de la Seguridad Social Chilena* (1964-1965)).

61. See *id.* at 29. This period included the presidencies of both Eduardo Frei (1964-70) and Salvador Allende (1970-73). See *id.*

62. See Mesa-Lago, *supra* note 50, at 108-09.

63. See *id.* at 105.

64. Mesa-Lago, *supra* note 42, at 29 (quoting República de Chile, *Mensaje del Presidente al Senado y la Cámara de Diputados*, Santiago, May, 1966).

b. *Reform Through Privatization*

Chile's future dramatically changed in 1973, when General Augusto Pinochet overthrew the government and took control in a military coup. The military dictatorship that followed proved to be the only form of government that successfully could overcome the pressure groups, bringing about true reform of the social security system and eventually, in 1980, privatization of the system.

Upon seizing control, Pinochet used his military power to overthrow the pressure groups, unions, and political parties, and he introduced many of the social security reforms that Alessandri's commission had proposed a decade earlier.⁶⁵ These reforms, implemented between 1974 and 1979, were aimed at eliminating costly privileges, establishing a uniform minimum benefit, fixing equal retirement ages across the system, and creating administrative interrelationships among the many separate pensions.⁶⁶

In 1980, recognizing the economic crisis facing Chile, Pinochet radically changed his policies by relaxing his tight control of the economy and enacting free market reform.⁶⁷ As part of this policy, Pinochet privatized the great majority of previously government-owned industry.⁶⁸

The privatization of Chile's social security system was integral to both the industrial privatization program and economic recovery in general. On November 4, 1980, Pinochet created a system of retirement pensions based on individual capitalization of retirement accounts invested with private pension fund managers, who were called Administradoras de Fondos de Pensiones, or AFPs.⁶⁹ The system essentially functions as a "compulsory private savings program."⁷⁰ Beginning in 1983, all new workers entering the workforce are required to contribute at least ten percent of their wages to an approved AFP of their choosing.⁷¹ Self-employed workers are not required to join an AFP, but have the option of doing so.⁷² Workers who leave the state system to join an AFP receive an advance on accumulated retirement contributions, so that prior con-

65. See Mesa-Lago, *supra* note 50, at 109.

66. See *id.*

67. See Rita Koselka, *A Better Way to Do It*, *Forbes*, Oct. 28, 1991, at 158, 158.

68. See Jean A. Briggs, *A Political Miracle*, *Forbes*, May 11, 1992, at 108, 109-110.

69. See Decree Law 3,500, tit. I, art. 1 (Chile 1980). The private social security system created by Decree Law 3,500 went into effect on May 1, 1981. See Decree Law 3,500, tit. X, art. 97 (Chile 1980).

70. Mesa-Lago, *supra* note 50, at 110.

71. See Decree Law 3,500, tit. III, art. 21 (Chile 1980). Contributions by employers are not required.

72. See Decree Law 3,500, tit. IX, art. 89 (Chile 1980). When the new social security system was established in 1981, workers were given until May, 1986 to change to the private system, and, prior to 1983, new workers could elect to enter the state-run system. See Robert J. Myers, *Privatización en Chile del Sistema de Seguridad Social, in Análisis de la Previsión en Chile* 13, 18 (Sergio Baeza ed., 1986).

tributions are not lost by switching to the AFP.⁷³

Currently there are sixteen operating AFPs, which function much like mutual funds in the United States.⁷⁴ The various AFPs compete for investors based primarily on fees and service.⁷⁵ There is little differentiation, however, among the rates of return of the various funds, due to strict government regulation of investments.⁷⁶ Despite heavy restraints on investment strategies, the AFPs consistently have outperformed the state-run social security system, averaging an annual real rate of return of thirteen percent during their first decade of operation.⁷⁷

The AFPs effectively have transferred the burden of administering social security in Chile to the private sector, while the state assumes a subsidiary role. By 1986, between eighty-five and ninety percent of all employees in Chile had changed their pensions to the privatized system,⁷⁸ and the old system is expected to disappear gradually over the next forty to fifty years.⁷⁹ The government's primary remaining responsibilities are to regulate the AFPs and to guarantee a basic minimum old-age pension for all retirees.⁸⁰

c. *Evaluation of the Privatization*

The privatization of social security in Chile undoubtedly has solved many of the problems that were inherent in the state-run system it supplanted. Perhaps the greatest accomplishment of the privatization of pensions, however, has been its positive effect on economic development in Chile, by stimulating national savings and investment.

For individual workers, Chile's privatized social security system represents a significant improvement over the old, state-run system. The distinguishing characteristics of the new system are individual saving and capitalization and freedom of choice. Because each worker maintains his or her own account, the level of each retiree's pension is related directly to the amount of the worker's contributions to the AFP throughout his

73. These advances are formally known as "Bonos de Reconocimiento." See Decree Law 3,500, tit. XI, art. 3-4 (Chile 1980).

74. The system is heavily influenced by American economics. The Minister of Labor under Pinochet who introduced the reform, Jose Piñera, is a Harvard-trained economist. See Briggs, *supra* note 68, at 109. Also, the largest of the sixteen AFPs, AFP Provida, is forty-two percent owned by the American firm Bankers Trust. See *id.*

75. See Saul Hansell, *The New Wave in Old-Age Pensions*, Institutional Investor, Nov. 1992, at 77, 81.

76. See *id.* The legislation created the "Superintendencia de Administradoras de Fondos de Pensiones" to register the AFPs and to regulate their operation. See Decree Law 3,500, tit. X, art. 93-97 (Chile 1980). There are limitations on the amount of money that may be invested in the Santiago Stock Market, as well as limitations on the amount of an AFP's assets that may be invested in any single company. In addition to this, investment performance is monitored closely, and substantial penalties are levied on funds that earn returns significantly below the norm. See Hansell, *supra* note 75, at 81.

77. See Koselka *supra* note 67, at 160.

78. See Myers, *supra* note 72, at 18.

79. See Mesa-Lago, *supra* note 50, at 111.

80. See Decree Law 3,500, tit. VII, art. 73-75 (Chile 1980).

or her working life.⁸¹ In addition, employees voluntarily may choose to deposit in excess of the mandatory ten percent contribution to their AFP account, to develop a greater retirement pension. Workers also benefit from the freedom of choice within the system. Because workers may choose among the various AFPs and may switch from one fund to another every six months, the AFPs must offer competitive fees and endeavor to invest profitably.⁸²

Most important, however, is the role played by Chile's privatized pension system in the country's economic resurgence during the past decade. The AFPs currently manage roughly \$12.5 billion worth of funds, a significant sum for a country of only thirteen million people.⁸³ While the state-run system only invested social security withholdings in government bonds, the AFPs have diversified their holdings to include private stocks and bonds.⁸⁴ These huge reserves of capital have stimulated private investment in Chile, and the economy has grown in response. For example, the Santiago Stock Market has boomed in recent years, largely because of money invested by the AFPs.⁸⁵ Of course, as the economy continues to expand, the AFPs will accumulate more wealth, which in turn may be invested, prompting further private economic growth. This upward spiral translates to a high rate of economic growth in Chile, averaging five percent per year.⁸⁶ Finally, the privatization of the social security system in Chile has been essential to industrial privatization, because the expanded pool of private savings created by the AFPs has enabled the government to sell off many of its subsidized holdings to private investors.⁸⁷

Thus, overall, the privatization of social security in Chile has been successful on several fronts.⁸⁸ For the individual, privatization eliminated the inequality and waste associated with the old state-run system and helped workers obtain more lucrative and secure pensions. Moreover, the AFPs have stimulated private saving and investment in Chile, and, therefore, overall economic development. Although a democratic government gained control of Chile in 1990,⁸⁹ these sweeping reforms would

81. See Hernán Cheyre Valenzuela, *La Previsión en Chile Ayer y Hoy: Impacto de una Reforma 184-85* (1988).

82. See *id.* at 187-88. Upon retirement, workers also have a choice as to the form of their pension: they may either contract with an insurance company to buy an annuity with the proceeds of their account to receive set periodic payments, or they may continue to maintain their AFP account and exercise more control over the disbursement of their pension. See Decree Law 3,500, tit. VI, art. 62-69 (Chile 1980).

83. See Hansell, *supra* note 75, at 78, 81.

84. See Koselka, *supra* note 67, at 160. The AFPs may invest up to fifty percent of their funds in private corporate debt and up to thirty percent in private corporate equities. See *id.*

85. See *id.*

86. See Briggs, *supra* note 68, at 110.

87. See Ed Rubenstein, *The Other Path*, *Nat'l Rev.*, Apr. 30, 1990, at 16, 16.

88. For a contrary view, see Jose Pablo Arellano, *Una Mirada Crítica a la Reforma Previsional de 1981*, in Baeza, *supra* note 72, at 81, 81-92.

89. See Briggs, *supra* note 68, at 108.

not have been possible without the political backdrop of Pinochet's military dictatorship, by which he promulgated the reforms by decree.⁹⁰ The cases of Argentina and Mexico demonstrate that in countries with democratic political processes, such far-reaching reforms must be achieved gradually and with compromises.

2. Argentina

As in Chile, social security in Argentina developed slowly over a period of many decades. Due to the power of political pressure groups in Argentina, the social security system developed in a stratified manner, marked by unequal benefits, administrative inefficiency, and high cost to the government. In recent years, President Carlos Saul Menem and Economic Minister Domingo Felipe Cavallo of Argentina initiated a widespread privatization program intended to reduce the fiscal burden on the government and to promote economic development.⁹¹ Menem and Cavallo based their plan for social security reform on the model established by Chile.

In September, 1993, the Argentine Senate passed a bill partially privatizing social security.⁹² The reform is less radical than that adopted in Chile in 1980, as workers have an option either to maintain their pension in the state-run system, or to transfer their retirement funds to a privately-managed account.⁹³ The case of Argentina demonstrates how, in a democratic political system as opposed to Pinochet's military junta in Chile, the legislative process works more slowly, and widespread reforms come about more gradually.

a. *Developments Before Privatization*

During the first century of Argentina's statehood, from its independence in 1810 to the turn of the twentieth century, the landed oligarchy dominated the government.⁹⁴ Throughout this period, government employees received extensive social security protection, while the majority of the workforce was unprotected.⁹⁵

Around the turn of the twentieth century, the organization of the Argentine labor movement forced the government to recognize the needs of

90. But see Angelo Codevilla, *Is Pinochet the Model?*, Foreign Aff., Nov.-Dec. 1993, at 127 (arguing that the Chilean model should not be followed because Pinochet's free-market reforms came at the expense of human rights and democracy).

91. See Ministerio de Economía y Obras y Servicios Públicos, Argentina: A Growing Nation 22 (1993) [*hereinafter* A Growing Nation].

92. See *Argentine Senate Passes Social Security Reform*, Reuters, Sept. 23, 1993, available in Westlaw, INT-NEWS database.

93. See *id.*

94. See Mesa-Lago, *supra* note 42, at 160-61.

95. Top civil servants received pensions in 1810, and national old-age security was granted to judges in 1877, and to public school teachers in 1885. See *id.* at 161.

the masses of non-government workers.⁹⁶ The Conservatives who controlled Argentina during this period, however, continually repressed the unions, which resulted in an increasing number of violent strikes in Argentina prior to 1915.⁹⁷ The growing power of labor eventually forced the Conservatives to appease the strongest union factions by passing some reform legislation, including, in 1915, a social security package for the railroad workers.⁹⁸ When Conservative rule ended in 1916, the new leader of the Radical Republic, Yrigoyen, slowly passed individual pieces of social security legislation to grant pensions to the most influential middle class pressure groups, which provided his base of political support.⁹⁹ One group at a time, pension coverage slowly expanded, but the government still gave little attention to the majority of workers.

Colonel Juan Domingo Perón was elected President of Argentina in 1946 and maintained control of the country for a decade. He owed much of his political power to the leaders of the labor movement, and, during his presidency, Perón laid the foundations for modern social security in Argentina.¹⁰⁰ While pension coverage expanded to include the majority of the workforce,¹⁰¹ stratification of the social security system in Argentina increased under Perón.¹⁰²

In the 1960s and 1970s, social security reforms in Argentina focused on trying to remedy the problems of inequality and stratification that pervaded the system during the Perón years. Unification of the system began in 1967, when General Juan Carlos Onganía, the leader of the military government, enacted legislation to consolidate several of the pension funds, which reduced administrative costs and facilitated regulation.¹⁰³ Returning to power in 1973, Perón attempted to continue the unification process, but his attempts proved unsuccessful because the return to democracy also revived the power of the pressure groups.¹⁰⁴

As social security developed in Argentina, the system provided adequate coverage for the population, but at a high cost to the government.¹⁰⁵ These costs became increasingly burdensome through the

96. *See id.* Railroad and printing workers were the first to organize, in 1887, and the first national workers' federation formed in 1901. *See id.*

97. *See id.* at 162. There was a general strike in Argentina in 1909, and a national railroad strike in 1912. *See id.*

98. *See id.*

99. *See id.* at 162-63.

100. *See id.* at 164-65.

101. Among the new groups to receive pensions were industrial workers, the self-employed, and professionals. *See id.*

102. During Perón's regime, a dozen new and distinct social security pension funds came into existence. *See id.* at 164, 170-71.

103. *See id.* at 166-67.

104. *See id.* at 167-68.

105. *See* Carmelo Mesa-Lago, *Social Security in Latin America and the Caribbean: A Comparative Assessment*, in *Social Security in Developing Countries* 356, 364-370 (Ehtisham Ahmad *et al.* eds., 1991). In 1985, 74.3 percent of the Argentine population was covered by social security, a high figure compared to other Latin American countries, *see*

1980s, as the Latin American debt crisis ravaged the Argentine economy.¹⁰⁶ In the meantime, social security expenditure as a percentage of Gross Domestic Product remained relatively constant during the same period, and even increased from 1990 to 1992.¹⁰⁷ In 1989, the Argentine economy hit rock bottom and exploded into hyperinflation.¹⁰⁸

b. *Reform Through Privatization*

Beginning at the bottom, in 1989, President Carlos Menem initiated a sweeping economic recovery program. Menem's primary goals were to reform the structure of the state,¹⁰⁹ reduce the government debt through refinancing,¹¹⁰ boost the economy with free market reform,¹¹¹ liberalize trade,¹¹² and increase production.¹¹³ Widespread privatization has been an "essential ingredient in the process of state reform."¹¹⁴ Thus far, the privatization program has been successful in reducing the deficit, encouraging investment to increase productivity, limiting costs of services, and strengthening Argentina's capital markets.¹¹⁵

Based on the model established by Chile, President Menem and Minister Cavallo also considered the privatization of social security to be an integral element of Argentina's overall development, because such a reform would promote growth through saving and investment.¹¹⁶ The state-run social security system worked against these aims, because it forced the government to use proceeds generated from industrial privatizations to pay for Argentina's indebted pension system.¹¹⁷

Argentina's democratic political framework prevented Menem from

id. at 370, but the system operated at a deficit, with social security expenditures representing thirty-eight percent of the national budget in 1980. *See id.* at 364.

106. *See A Growing Nation, supra* note 91, at 19-22. Public debt in Argentina rose throughout the 1980s to peak in 1989. Internal public debt reached seventeen billion U.S. dollars in the first quarter of 1989. *See id.* at 19. External public debt also peaked in 1989, reaching 59.7 percent of Gross Domestic Product. *See id.* at 22.

107. *See id.* at 6-7.

108. Consumer prices in Argentina rose 4,923.6% in 1989. *See id.* at 3.

109. *See id.* at 4.

110. *See id.* at 19.

111. *See id.* at 25.

112. *See id.* at 32.

113. *See id.* at 35.

114. *Id.* at 16.

115. *See id.* at 16-17.

116. *See id.* at 27-29.

117. *See Argentine Government Owes Pensioners \$12 Billion*, Reuters, July 8, 1993, available in Westlaw, INT-NEWS database. On July 7, 1993, Cavallo announced that the government was indebted to pensioners in the amount of twelve billion dollars, and that almost sixty percent of the proceeds generated by the privatization of the national petroleum company, Yacimientos Petroliferos Fiscales, as well as proceeds from other Argentine privatizations, would be spent to satisfy this debt. *See id.* The state-run pension system was created under the presumption that there were four workers for each retiree, but in Argentina presently each retiree is supported by only 1.5 members of the workforce. *See Argentine Lower House Approves Pension Reform Bill*, Reuters, Apr. 30, 1993, available in Westlaw, INT-NEWS database.

reforming social security in Argentina as drastically and as rapidly as Pinochet had done in Chile. Menem's initial proposal called for a mandatory private pension scheme, much like that Pinochet introduced in Chile.¹¹⁸ However, the power of the labor unions—one of the legacies of the former President Perón—delayed congressional passage of the bill for more than a year, until amendments were added that made private pensions optional rather than mandatory.¹¹⁹ The final version of the bill, passed by the Argentine Senate on September 23, 1993, also was further revised to include amendments discouraging banks and insurance companies from managing private pension funds, and establishing Argentina's central bank, Banco de la Nación, as a pension administrator and guarantor of a minimum return.¹²⁰ Bankers and economists criticized the amendments, stating that the presence of the central bank would impede competition and the state-guaranteed minimum posed a long-term threat to fiscal stability.¹²¹ Nonetheless, representatives of the Argentine government praised the new legislation as "a fundamental change in our social security system."¹²² Cavallo "want[ed] the pension funds to be up and running as soon as possible."¹²³ President Menem also stated that the privatization of pensions, coupled with other recent reforms, are "strengthen[ing] the state's capacity to devote itself to its fundamental tasks—health care and education, justice and security"¹²⁴

c. *Evaluation of Privatization*

While it is too early to know the effects of the new legislation on the Argentine economy, the private pension funds probably will have a positive effect on saving and investment. Because participation in the system is optional rather than mandatory, it is doubtful that the net effect of the

118. *See Argentine Gov't Accepts Pension Bill Amendments*, Reuters, Apr. 28, 1993, available in Westlaw, INT-NEWS database.

119. *See id.*; *Argentine Lower House Approves Pension Reform Bill*, Reuters, Apr. 30, 1993, available in Westlaw, INT-NEWS database. Argentina's largest labor union, CGT, had previously delayed the legislation during the drafting stage until the bill was amended to allow unions to participate as fund managers in the private system. *See Banco Velox*, Anuario-92: Business Trends 33 (1992).

120. *See Argentine Senate Passes Social Security Reform*, Reuters, Sept. 23, 1993, available in Westlaw, INT-NEWS database; *Argentine Pensions Bill to Undergo More Amendments*, Reuters, May 13, 1993, available in Westlaw, INT-NEWS database.

121. *See Argentines Say Pension Bill Is Better Than No Bill*, Reuters, Sept. 24, 1993, available in Westlaw, INT-NEWS database.

122. *See Argentine Senate Passes Key Social Security Reform*, Reuters, Sept. 23, 1993, available in Westlaw, INT-NEWS database (quoting senate speaker Eduardo Menem, brother of President Saul Menem).

123. *See Menem To Review Argentine Pension Reform Law*, Reuters, Oct. 12, 1993, available in Westlaw, INT-NEWS database. The government is, however, now trying to submit complimentary legislation that would reduce the role of the central bank. *See Argentina to Amend New Private Pensions Law*, Reuters, Oct. 13, 1993, available in Westlaw, INT-NEWS database.

124. Nathan Gardels & Abraham Lowenthal, *Disappearing the State in Argentina*, New Persp. Q., Fall 1993, at 8 (interview with President Carlos Saul Menem).

privatization will be as great in Argentina as in Chile.¹²⁵ The case of Argentina demonstrates the difficulty of effectuating social security reform in a democracy.¹²⁶ Even in an environment in which the transfer of economic power and responsibility from the state to private companies is encouraged, it can be especially difficult to bring about sweeping reform in social security because people are suspicious of any change that might threaten their pension benefits.¹²⁷ This provides insight into the potential difficulties of privatizing old-age pensions in the United States.

3. Mexico

Social security developed later in Mexico than in Chile and Argentina. By the 1980s, the Mexican system was more unified than those in Chile and Argentina, but the pension coverage it provided was seriously inadequate. In February, 1992, the Mexican government enacted legislation that reformed the existing system to provide better pensions for workers.¹²⁸ The new law also instituted a supplemental pension sub-account that placed funds in the hands of Mexico's newly-privatized commercial banks, intending to promote long-term savings and develop Mexico's capital markets.¹²⁹ The case of Mexico illustrates the interaction between private pensions and capital markets, and shows that a relatively small transfer of social security money to private fund managers can significantly affect the level of private saving and investment.

a. *Developments Before Privatization*

The first century of Mexican independence following its revolution from Spain in 1821 was marked by the absence of a strong central government and the concentration of power in the hands of relatively few wealthy land owners.¹³⁰ At first, the conservative elite maintained a local power structure, which served only to increase social stratification and perpetuate anarchy.¹³¹ The ensuing liberal regime centralized the government, but chose to maintain a laissez-faire economic policy, which served to concentrate further economic power in the hands of the wealthy.¹³² The effect of this trend on social security was that until the 1920s, only selected civil servants in Mexico received old-age pensions

125. Early estimates predict that seventy percent of Argentina's workers will switch to the private funds when the new system goes into effect in July, 1994, which would significantly boost national savings. See *Argentina Sees Massive Switch to New Pensions Plan*, Reuters, Dec. 14, 1993, available in Westlaw, INT-NEWS database.

126. See Hansell, *supra* note 75, at 82.

127. See *id.*

128. See Catherine Mansell Carstens, *The Retirement Savings System: Mexico's Revolutionary Pension Fund Reform*, Bus. Mex., Apr. 1992.

129. See *id.*

130. See Mesa-Lago, *supra* note 42, at 208-12.

131. See *id.* at 209.

132. See *id.*

from the government.¹³³

In 1917, the Mexican government adopted a new Constitution, which recognized the interests of labor for the first time.¹³⁴ The Constitution's provisions regarding social security, however, were vague, and no real advances in pensions came for several years. Between 1925 and 1942, the government slowly passed legislation, establishing pension funds for different employee groups. Still, the groups covered by these laws came only from the most powerful pressure groups and unions, including civil servants who received pensions in 1925, the military (1926), teachers (1928), and workers in the petroleum (1935), railroad (1938), and electricity (1941) industries.¹³⁵ General Lázaro Cárdenas, who served as Mexico's president from 1934 to 1940, made several unsuccessful attempts to enact a federal social security law for the masses of workers.¹³⁶

In 1943, Cárdenas's successor, General Manuel Avila Camacho, finally succeeded in introducing a national system of social security.¹³⁷ This legislation granted pensions to the mass of urban blue and white-collar workers, and created the Mexican Institute of Social Insurance, or IMSS, to administer the system, a role the IMSS still plays today.¹³⁸

The Mexican social security system slowly grew under the control of the IMSS from the 1950s to the early 1970s, but the percentage of the population that received pensions remained low.¹³⁹ In 1973, new legislation stressed the importance of expanding pension coverage, in order to avoid " 'deepen[ing] the differences among the inhabitants of the country,' perpetuating a 'dual society with a few privileged members and a majority [without protection].' " ¹⁴⁰ The legislation also warned, however, that rapid expansion could endanger the financial stability of the IMSS. By 1980, social security covered fifty-three percent of the Mexican population, a growing figure, but one which still fell far short of that achieved by Chile, Argentina, and other Latin American countries that enacted comprehensive social security systems before Mexico.¹⁴¹

In addition to the problem of inadequate coverage, in the 1980s the Mexican social security system also faced the problems of high cost to the government and an inability to promote savings and investment. The

133. See *id.* at 208-12.

134. See *id.* at 212. The 1917 Constitution, which is still in effect, was the first in Latin America to recognize workers' rights, and it included provisions for equal wages for equal work, a maximum workweek, and prohibitions on child labor. See *id.*

135. See *id.* at 212-15, 220.

136. See *id.* at 215.

137. See *id.* at 215-16.

138. See *id.*

139. See *id.* at 217-19. Rural workers received pensions in 1954, but IMSS covered only seven percent of Mexico's total population in 1958, and twenty-five percent of the population in 1970. See *id.* In 1971, IMSS did not cover seventy-eight percent of Mexico's municipalities. See Mesa-Lago, *supra* note 50, at 150-51.

140. *Id.* at 146 (quoting IMSS, *Instituto Mexicano del Seguro Social 1943-1983: 40 Años de Historia* 47-49 (1983)).

141. See Mesa-Lago, *supra* note 105, at 364-65.

administrative costs of social security in Mexico are among the highest in Latin America.¹⁴² Considering the fact that employee contributions to social security in Mexico are well below those figures for other countries, it is apparent that the IMSS is a fiscal drain on the government.¹⁴³ Although Mexico's population is still relatively young, it has expanded rapidly since 1960,¹⁴⁴ suggesting that when Mexico's baby boomers retire the IMSS will be unable to pay for their pensions.

The state-run social security also failed to promote saving and investment in Mexico. This was largely a result of the failure of the system to offer any incentives for individuals to save. Not only did real wages fall drastically during the 1980s, providing workers with less income available for private saving,¹⁴⁵ but high inflation during the same period¹⁴⁶ meant that workers who did choose to put money away were not offered a positive return on their investment.¹⁴⁷

b. *Reform Through Privatization*

To combat the problems of providing financial security in retirement for Mexico's workers and promoting long-term savings,¹⁴⁸ on February 8, 1992 the Mexican Chamber of Deputies approved a law enacted by decree by President Carlos Salinas de Gotari. This legislation's intent was to reform the state-run social security system and establish a supplemental private pension system, called the Sistema de Ahorro para el Retiro, or SAR.¹⁴⁹ Influenced by Chile's privatization and the creation of the AFPs, the SAR offers workers a supplement rather than an alternative to social security pensions.¹⁵⁰ Just as before the enactment of the reform, workers pay 7.4% of their salaries in taxes to the IMSS, which uses the money to finance government pensions for current retirees.¹⁵¹ Prior to the reform, a separate 5% tax on wages was paid to a government housing fund. Under the new legislation, that money now is deposited by the employers in the Bank of Mexico, the country's central bank.¹⁵² The government guarantees workers a post-inflation annual rate of return of at least two percent on these deposits, thereby creating

142. See Mesa-Lago, *supra* note 50, at 165.

143. See Stanley Holt, *Private Pension Plans: Whose Security?*, Bus. Mex., June 1991 (In 1989, Mexican workers contributed seven percent of their salaries to social security, compared to 11.2 percent in the United States and 13.2 percent in Chile.).

144. The Mexican population grew from 34.9 million in 1960 to eighty-two million in 1992. See Carstens, *supra* note 128.

145. See Holt, *supra* note 143.

146. Inflation in Mexico reached 159% in 1987 and dropped to about twenty percent in 1991. See *id.*

147. See Carstens, *supra* note 128.

148. See Holt, *supra* note 143.

149. See *Chamber of Deputies Approves Modifications to the Social Security System*, Ins. Res. Letter, June 7, 1992, available in Westlaw, INT-NEWS database.

150. See Holt, *supra* note 143.

151. See Carlos Salinas de Gotari, 1992 Cuarto Informe de Gobierno 89.

152. See *id.*

an incentive for private saving.¹⁵³

The most dramatic aspect of the new law is an additional tax of two percent on workers' salaries, paid by employers and deposited in Mexico's commercial banks,¹⁵⁴ which were privatized in 1991 and 1992.¹⁵⁵ The banks are required to invest these funds in government bonds, which are guaranteed to pay a two percent real rate of return.¹⁵⁶ A second stage of the reform, which was scheduled to begin in January, 1993, but has been delayed,¹⁵⁷ grants employees the option to transfer the funds of these supplemental accounts from the private commercial banks to other private investment fund managers and insurance companies.¹⁵⁸ Although these investment managers are not required to guarantee any minimum return, they likely will offer higher yields than banks because they will be permitted to invest in private sector stocks and bonds.¹⁵⁹

c. *Evaluation of Privatization*

Clearly, the SARs do not represent a full scale privatization of Mexican social security to the extent that the AFPs do in Chile. Only two percent of wages out of a total pension contribution of 14.4% are managed privately,¹⁶⁰ and this is the only portion of retirement contributions over which Mexican employees exercise any control.

The incremental approach to social security reform in Mexico results from the relative stability of the Mexican government and economy. Unlike in Chile, where privatization was a response to fiscal crisis, Mexico reformed its social security toward the end of a successful industrial privatization program, which had already set the economy moving in the right direction. President Salinas therefore could afford to institute a more moderate reform, intended to complement a progress already in effect.¹⁶¹

Mexico's new, partially-privatized social security system should reach

153. *See id.*

154. *See id.* This tax is paid by employers essentially through a mandatory two percent raise in wages, because initially employees could not afford the added tax burden. Eventually the burden of funding this supplemental account will shift to employees. *See id.*

155. *See* Scott Schulz, *Miles to Go*, Latin Fin., July-Aug. 1993, at 35, 35.

156. *See* Carstens, *supra* note 128.

157. *See Mexico: Calm After the Storm*, Euromoney Supplements, Jan. 20, 1993, at 18.

158. *See* Carstens, *supra* note 128.

159. *See id.*

160. *See supra* note 154 and accompanying text.

161. *See* Hansell, *supra* note 75, at 83. Of course, the fact that Mexico's democracy consists of only a single party further facilitated reform, as Salinas was able to enact his legislation by decree, avoiding the type of political struggle that Menem faced in Argentina. *See id.*; *supra* notes 118-24 and accompanying text. There were some complaints from different political pressure groups in Mexico. Labor representatives opposed workers' lack of control over the bulk of their savings. *See* Holt, *supra* note 143. Some employers contended that their additional tax burden of two percent was unfair. *See* Carstens, *supra* note 128. And current retirees complained that their pensions were not increased by the reform. *See id.* at 13-14. None of these groups was powerful enough,

its twin goals of furnishing secure retirements for Mexico's workers and boosting Mexico's low rate of savings.¹⁶² The SARs provide a substantial source of retirement income for workers at no additional cost. Furthermore, the restructuring of the state-run social security system guarantees a positive rate of return on workers' savings and represents the government's solid commitment to the Mexican workers. Finally, workers have additional security through the "alternative . . . of maintaining his [SAR] investment in a safe asset."¹⁶³

The new pension system also should promote savings and accelerate the development of Mexico's capital markets, though not as rapidly as in Chile, due to the "relatively small size of the contributions."¹⁶⁴ Nevertheless, some observers project that the assets of the supplemental SAR accounts will reach \$10.5 billion by the year 2000, providing vast investment resources for Mexico's privatized banks.¹⁶⁵

Chile, Argentina, and Mexico are the three most prominent examples of social security privatization in Latin America, but they are not the only countries to issue such reforms. In fact, social security privatization has been adopted or is being considered by most of the countries in the region.¹⁶⁶

III. CAN PRIVATIZATION BE A FEASIBLE ALTERNATIVE FOR SOCIAL SECURITY REFORM IN THE UNITED STATES?

The case studies of social security reform in Chile, Argentina, and Mexico demonstrate the benefits of replacing or supplementing a state-run, "pay-as-you-go," social security system with a private pension program. These reforms provide workers with greater insurance that their retirements will be funded, because each worker's pension is a direct result of the contributions he or she makes during the working years. By increasing the incentive to save, the national rate of savings rises, providing a substantial source of funds for private pension managers to invest in

however, nor were their complaints forceful enough to prevent Salinas from issuing his decree. See Holt, *supra* note 143.

162. See *id.*

163. Hansell, *supra* note 75, at 83 (quoting Agustín Carstens).

164. *Id.* at 84. The magnitude of the effect will increase dramatically if, as some predictions indicate, the government increases the contribution rate to the SARs. See *id.*

165. See *id.*; Carstens, *supra* note 128.

166. See, e.g., William R. Long, *Pensions in Chile Pay Off Handsomely*, L.A. Times, Sept. 28, 1993, World Report, at 4 (discussing privatization in Chile as a model followed throughout Latin America). Peru adopted a system similar to that in Argentina, that went into effect on June 21, 1993, and over fifty thousand workers opted to place their retirement money in the private funds during their first three weeks of operation. See *Over 53,000 Peruvians Join Private Pension Fund*, Reuters, July 13, 1993, available in Westlaw, INT-NEWS database. For examples of proposed reforms in other Latin American countries, see, e.g., *Brazil: Pension Market Overview—A Growth Industry*, Global Money Mgmt., Feb. 22, 1993, at 13, available in Westlaw, INT-NEWS database; *Colombia President Approves New Social Security*, Reuters, Dec. 23, 1993, available in Westlaw, INT-NEWS database.

private capital markets. This increased investment spurred substantial economic growth in Chile during the past decade, and is expected to produce similar effects in Argentina and Mexico. The Latin American models, however, do not show conclusively whether privatization can work as a plan for social security reform in an industrial nation with a mature economy such as the United States. In the United Kingdom, it has.

A. *"Contracting Out" of Social Security in the United Kingdom and the Personal Pension Scheme*

The first national old-age pension legislation in the United Kingdom was the Old Age Pension Act of 1908.¹⁶⁷ In its operation, however, this law was not much different from a welfare program; pensions were not supported by tax revenues, and strict means testing ensured that only low-income individuals would receive assistance.¹⁶⁸ The 1908 Act was replaced by new pension legislation in 1925, that, for the first time, funded retirees pensions out of taxes received from employees and employers. Although there were no restrictions on who was required to pay the tax, means testing continued to restrict the distribution of pensions.¹⁶⁹

Sir William Beveridge first proposed the concept of a universal retirement pension program in the United Kingdom during the 1940s.¹⁷⁰ In 1942, Beveridge published a report entitled *Social Insurance and Allied Services*, commonly called the *Beveridge Plan*.¹⁷¹ In it, Beveridge advocated a comprehensive and universal system of social insurance to reach the goal of guaranteeing every citizen a basic minimum retirement income without the use of a means test.¹⁷² Based on these principles, Parliament enacted the National Assistance Act of 1948, providing a basic flat rate pension based on a flat rate tax for all men over the age of sixty-five and all women over the age of sixty.¹⁷³

In 1959, Parliament passed further legislation that added an earnings-related component to the basic pension coverage of the National Assistance Act.¹⁷⁴ The most noteworthy aspect of the 1959 law was that workers could opt out of the earnings-related "second tier" of pension coverage if they already were covered by a private pension plan that offered benefits that were equal to or greater than the government alterna-

167. See John C. Goodman, *Social Security in the United Kingdom: Contracting Out of the System 6-7*, (1981). This legislation replaced private insurance institutions called "friendly societies," which provided care for retirees in exchange for payments during their working years. See *id.*

168. See Williamson & Pampel, *supra* note 9, at 50-51.

169. See *id.* at 51-52.

170. See Goodman, *supra* note 167, at 10.

171. See *id.* at 9-11.

172. See *id.*

173. See *id.*

174. See *id.* at 11.

tive.¹⁷⁵ Individual workers, however, could not opt out on their own; this alternative was offered collectively to all workers covered by each private pension plan.¹⁷⁶

The Social Security Pensions Act of 1975 increased further the private component of social security in the United Kingdom.¹⁷⁷ Beginning in April, 1978, employers could elect to "contract out" of social security.¹⁷⁸ Rather than pay full taxes to the government, an employer could choose to have both it and its employees make contributions to approved private pension fund managers.¹⁷⁹ By requiring the private pension managers to guarantee a minimum benefit equal to the government's benefit and have this guarantee indexed for inflation, this legislation also provided added security.¹⁸⁰ In the first five years following the implementation of the 1975 Act, forty-five percent of employers in the United Kingdom opted to contract out of social security.¹⁸¹ The biggest problem was that the choice to contract out still belonged to the employer, not the employees.¹⁸² All employees of a company were treated the same, regardless of their age, income level, or pension needs.¹⁸³

While the contracting-out system under the 1975 legislation did reduce considerably the burden of social security on the British government,¹⁸⁴ further privatization was not far behind. With the Social Security Act of 1986, the bulk of the responsibility for pension shifted from the government to individual workers.¹⁸⁵ The 1986 Act reduced the benefits provided under the State Earnings Related Pension Scheme, or SERPS, to induce workers to switch their pensions away from the government.¹⁸⁶ In addition, workers now may elect not to participate in an employer's pension program, and contribute instead to an approved Personal Pension Scheme, or PPS, of the worker's own choosing.¹⁸⁷ In addition, as an incentive for workers to withdraw from SERPS, the PPS initially provided an added financial benefit.¹⁸⁸

Through this legislation, the government of the United Kingdom effectively has privatized a substantial portion of its social security system. In

175. *See id.* at 11-14.

176. *See id.*

177. *See* Social Security Pensions Act, 1975, ch. 60 (Eng.).

178. *See id.* § 32.

179. *See* Goodman, *supra* note 167, at 43.

180. *See* Social Security Pensions Act, 1975, ch. 60, § 35 (Eng.).

181. *See* John C. Goodman, *Private Alternatives to Social Security: The Experience of Other Countries*, in *Social Security: Prospects for Real Reform* 103, 107 (Peter J. Ferrara ed., 1985).

182. *See id.*

183. *See id.*

184. *See* Goodman, *supra* note 181, at 107.

185. *See* Social Security Act, 1986, ch. 50 (Eng.).

186. *See id.* §§ 1-5.

187. *See id.*

188. *See* Joanne Wojcik, *A Global Shift Toward Private Pension Plans*, *Bus. Ins.*, Oct. 4, 1993, at 37. The government also is considering eliminating its Guaranteed Minimum Pension, to reduce further its fiscal burden. *See id.*

doing so, it initiated long-term reform, which will ensure the future viability of old-age security and enable the government to reduce its budgetary expenditures.

The case of the United Kingdom is only one example of a worldwide trend toward privatized pension systems.¹⁸⁹ In addition to the Latin American countries that now employ some private alternative to social security, various countries in Asia, Europe, and Australia rely on private alternatives to supplement or replace state-run social security.¹⁹⁰ The United States would be wise to privatize social security pensions at least partially in order to prevent the future collapse of the old-age safety net.

B. *Some Degree of Privatization Would Benefit the Social Security System in the United States*

Despite great disparity in the level of economic development, the United States confronts similar problems as Latin American countries in evaluating Social Security. Primary among these concerns is the need to insure the retirements of today's working generation and stimulate the national savings rate, which would lead to increased investment and economic growth.

The Latin American case studies demonstrate how privatization of pension systems can be implemented to resolve the long-term deficiencies of a state-run social security system. In Chile, where the new pension system has been in place for over a decade, privatization has reduced the fiscal burden of social security on the government by shifting the financial responsibility for retirement to the individual.¹⁹¹ The reform has benefitted individual workers in Chile as well as the economy as a whole. Individuals receive a more secure and lucrative pension on their retirement. The economy benefits because the balances of the private pension accounts are invested in Chile's capital markets, increasing national savings and stimulating the economy through investment. In Argentina and Mexico, similar systems are now in place, with similar visions of success for the future. In these countries, the reform-minded governments hope that the privatization of a portion of their social security systems will provide both a secure future for their workers and stimulate economic development.

Private pensions previously have been introduced unsuccessfully in Congress. In 1991, Senator Daniel Patrick Moynihan proposed a reduction in the Social Security payroll tax, which would allow individuals to exercise more control over their retirement money.¹⁹² The attorney and economist Peter J. Ferrara further has embraced the idea of private pen-

189. *See id.*

190. *See* Peter J. Ferrara, *Marching Toward Freedom*, Nat'l Rev., July 9, 1990, at 38 (pointing to a 1988 study that reported that twenty-nine countries have privatized at least a portion of their social security retirement benefit system).

191. *See supra* notes 81-90 and accompanying text.

192. *See* Ferrara, *supra* note 190, at 38.

sions. Ferrara suggests a system similar to that of Chile, where employees would each maintain their own "Super IRA," a mandatory private savings account.¹⁹³ Critics of Ferrara's proposals cite the cost to today's workers of financing both the pensions of current retirees through Social Security and their own retirements through a Super IRA.¹⁹⁴

Though politically difficult to implement, the privatization of retirement savings in the United States could be a great success. Such sweeping reform could be achieved only slowly, not like in Chile under Pinochet in 1980. The United States gradually should bring about a transfer of retirement funds to private accounts, more akin to the reforms in Argentina or Mexico, while keeping Social Security in place to guarantee a minimum pension only for the most needy retirees.

CONCLUSION

A gradual implementation of privatization of Social Security in the United States would increase national saving and investment, thereby promoting economic growth. By shifting the burden of pensions away from the federal government, the government could reduce its budget deficits and, in the long-term, avert a crisis when there are too many retirees to be supported using current Social Security tax withholdings. Also, privatization would mandate lower income workers to save and invest. This could make financial capital markets more accessible to low wage earners than has been customary, opening the possibility for some degree of reallocation of what is currently an unequal distribution of wealth in the United States.

193. See Peter J. Ferrara, *Social Security and the Super IRA: A Populist Proposal*, in *Social Security: Prospects for Real Reform* (Peter J. Ferrara ed., 1985), at 193, 194-97.

194. See Michael J. Boskin, *Too Many Promises: The Uncertain Future of Social Security* 100-04 (1986).